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Achieving the internationally agreed development goals, including those contained in the Millennium Declaration, as well as implementing the outcomes of the major United Nations conferences and summits: progress made, challenges and opportunities

World Economic Situation and Prospects as of mid-2005**

Summary

The growth of the world economy has slowed since the beginning of 2005. The moderation seems benign, or even desirable, given the overheated demand and constrained capacity in some sectors and in some regions. Nevertheless, accommodative macroeconomic policies should be maintained in most countries to prevent growth from weakening further. At the same time, more active domestic and international measures should be adopted to address the various imbalances and disequilibria that are currently creating downside risks for the world at large.

The major constraints facing the world economy include widening external imbalances across major regions, the unwinding of the policy stimuli of the past few years and higher prices of energy and of other primary goods. The higher commodity prices are a partial rebound from the secular downtrend of the past decades, with most of these prices still below their historical highs in real terms. While the higher prices have had some adverse effects on both developed and developing economies that import these materials, the majority of developing countries have benefited from the increased demand and the higher prices. The challenge is to ensure that the higher prices do not choke global growth and lead to another precipitous fall in prices. An additional challenge for the countries that produce and export oil and raw materials is to make a better use of the increased revenues to restructure their economies so as to reduce their vulnerability to the vicissitudes of commodity prices in the longer run.

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** The present document was submitted late in order to take into account the outcome of the meeting of Project LINK held from 16 to 20 May 2005 at Autonomous University of Mexico, Mexico City.

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The rise in commodity prices has suggested a gap between supply and demand in certain sectors, triggering increasing concern about inflation. Overall, however, there remains underutilized capacity in the world economy as whole, as indicated by the large amount of unemployment and underemployment in many countries, particularly, but not exclusively, most developing countries and many economies in transition. Since inflation does not currently pose a threat for the global economy, short-term macroeconomic policies should focus on raising real output and employment.

The global imbalances, overwhelmingly reflected in the large current-account deficit of the United States of America, continue to widen, heightening the risk of a disorderly adjustment in financial markets and in global growth. The imbalances involve a confluence of cyclical, structural and institutional factors. This implies that a realignment of exchange rates is unlikely to be sufficient to achieve the necessary degree of rebalancing. Various measures in both deficit and surplus countries, in a context of international coordination and cooperation, are needed to avert a deleterious reversal of the imbalances. In the longer run, it is necessary to reform the international monetary, financial and trade systems in order to reduce the dependency of global growth on a continuation of the external deficit of the United States.

The international economic environment for developing countries remains propitious as international trade continues to grow robustly, the costs of external financing are at historical lows and capital inflows are increasing. Nevertheless, for the poorest countries with limited access to international trade and financial markets, external market conditions alone do not provide sufficient impetus for them to achieve the Millennium Development Goals and other internationally agreed development objectives. Policymakers in both developed and developing countries should therefore expedite the implementation of their international development commitments of recent years, most notably in the areas of official development assistance, debt relief and trade.

One of the universal weaknesses in the world economy continues to be the slow growth of employment and the persistence of high rates of unemployment and underemployment in most developing countries. Unless improved economic growth is reflected in increased employment, it will prove difficult to reduce poverty. Governments therefore need to give greater priority to employment creation as a development objective.

Global economic momentum

After growth of 4.1 per cent in 2004, the strongest and broadest in the world economy for a number of years, the global expansion has decelerated in 2005. The moderation had been anticipated[1] because part of the momentum in 2004 was cyclical and was unlikely to be sustained in the face of a number of strengthening headwinds: rising prices of crude oil and other commodities, widening external imbalances across regions and a widespread unwinding of macroeconomic policy stimuli. Downside risks for the world economy remain, particularly those associated with the growing global imbalances, but global economic policies remain prudent and accommodative to growth. Gross world product (GWP) is expected to grow more than 3 per cent annually in 2005-2006 (see table 1).

Table 1
Growth of world output, 2000-2006
(Annual percentage change)

	2000	*2001*	*2002*	*2003*	*2004[a]*	*2005[b]*	*2006[b]*
World output[c]	3.9	1.4	1.8	2.6	4.1	3.25	3.5
of which							
Developed economies	3.4	1.0	1.2	1.9	3.3	2.5	2.5
Northern America	3.8	0.8	2.0	3.0	4.3	3.0	3.0
Western Europe	3.5	1.7	1.1	0.9	2.4	2.0	2.25
Asia and Oceania[d]	2.5	0.4	0.0	1.5	2.8	1.75	2.0
Economies in transition	8.3	5.7	5.1	7.1	7.6	6.0	5.25
Southern and Eastern Europe	3.7	5.0	4.7	4.2	6.4	5.0	4.5
Commonwealth of Independent States	9.3	5.9	5.1	7.6	7.8	6.25	5.5
Developing economies	5.7	2.4	3.5	4.6	6.6	5.75	5.75
Africa	3.3	3.4	3.3	4.2	4.5	5.25	5.25
East Asia	7.7	3.8	6.1	6.0	7.5	6.75	6.75
South Asia	5.2	4.7	4.5	6.6	7.0	7.0	7.0
Western Asia	5.5	-1.3	2.5	4.5	6.5	5.25	5.0
Latin America and the Caribbean	4.1	0.5	-0.4	1.8	5.6	4.25	4.25
Other groupings							
Landlocked countries	2.7	4.2	5.1	3.9	5.9	6.0	6.0
Least developed countries	4.7	5.1	4.9	4.0	5.0	5.5	5.75
Small island developing States	7.9	0.4	2.2	1.7	5.4	4.25	4.5
Sub-Saharan Africa[e]	2.7	3.9	3.9	3.2	5.5	5.75	6.0

(Footnotes on following page)

[1] See, for example, *World Economic Situation and Prospects 2005* (United Nations publication, Sales No. E.05.II.C.2); the present document updates that publication to end-May 2005.

(Footnotes to Table 1)

Source: Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA).

[a] Partly estimated.

[b] Forecasts, based in part on Project LINK, an international collaborative research group for econometric modelling, coordinated jointly by the Economic Monitoring and Assessment Unit of the United Nations Secretariat, and the University of Toronto.

[c] Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 2000 prices and exchange rates.

[d] Japan, Australia and New Zealand.

[e] Excluding Nigeria and South Africa.

The slowdown forecast for 2005-2006 is similar to that expected at the end of 2004, with the deterioration almost entirely concentrated in the developed countries. Growth in Western Europe is expected to be less than previously forecast, but the situation is the opposite in the developing countries. Although the performance of the developed countries remains the main determinant of global growth, this dichotomy suggests some degree of delinking between the developed and the developing countries, partially attributable to the evolving patterns of trade (see below) but also to the fact that domestic demand is playing a more important role in the developing countries because of the more stable economic and, in some cases, political conditions within those countries.

One unusual aspect of the present pattern of global economic growth is that it is widespread among developing countries and economies in transition. Long-standing disparities in growth among developing regions remain, but they are somewhat diminished and all developing regions are performing well by their respective standards of the past few decades. The breadth of the expansion is reflected in the fact that the number of developing countries in which output per capita rose by more than 3 per cent doubled between 2002 and 2004, when almost half of these countries, accounting for over 80 per cent of the developing world's population fell into this category in 2004 (see table 2). Moreover, this broad pattern of growth is expected to continue to prevail in 2005 and 2006.

Table 2
Frequency of high and low growth of per capita output, 2002-2004

		Decline in GDP per capita			*Growth of GDP per capita exceeding 3 per cent*		
	Number of countries monitored	*2002*	*2003*	*2004[a]*	*2002*	*2003*	*2004[a]*
		Number of countries					
World	159	38	36	16	45	59	83
of which							
Developed economies	33	2	5	0	9	9	15
Economies in transition	19	2	0	0	13	16	18
Developing countries	107	34	31	16	23	34	50
of which							
Africa	51	14	17	11	11	16	19
East Asia	13	1	2	1	7	5	10

	Number of countries monitored	Decline in GDP per capita			Growth of GDP per capita exceeding 3 per cent		
		2002	2003	2004[a]	2002	2003	2004[a]
		Number of countries					
South Asia	6	1	0	0	2	3	5
Western Asia	13	7	4	2	2	6	7
Latin America	24	11	8	2	1	4	9
Memorandum items							
Landlocked developing countries	26	8	6	5	9	11	11
Least developed countries	41	13	14	11	11	11	15
Small island developing States	17	6	7	3	1	5	5
Sub-Saharan Africa[b]	44	13	17	11	11	12	16
	Share[c]	Percentage of world population					
Developed economies	15.5	2.1	1.9	0.0	0.7	1.3	6.3
Economies in transition	5.6	0.2	0.0	0.0	4.7	4.7	5.3
Developing countries	78.9	8.0	10.5	3.1	34.4	53.5	64.7
of which							
Africa	13.2	2.3	3.3	1.4	2.5	5.5	5.0
East Asia	31.0	0.1	0.9	0.8	28.9	27.2	29.7
South Asia	23.4	0.4	0.0	0.0	1.5	18.5	23.4
Western Asia	2.8	1.3	0.8	0.6	1.1	1.6	1.7
Latin America	8.5	4.0	5.5	0.2	0.4	0.8	4.9
Memorandum items							
Landlocked developing countries	4.9	1.3	1.9	0.9	1.3	1.2	2.5
Least developed countries	10.7	2.0	3.1	2.2	3.3	2.3	5.9
Small island developing States	0.8	0.3	0.4	0.2	0.0	0.1	0.1
Sub-Saharan Africa[b]	8.2	2.2	3.3	1.4	2.5	2.3	3.6

Source: UN/DESA, including population estimates and projections from *World Population Prospects: The 2000 Revision*, vol. I, *Comprehensive Tables* and corrigendum (United Nations publication, Sales No. E.01.XIII.8 and Corr.1).

[a] Partly estimated.

[b] Excluding Nigeria and South Africa.

[c] Percentage of world population in 2000.

In the context of the challenge of achieving the Millennium Development Goals, one feature of the present situation is the resurgence of growth in sub-Saharan Africa. Several of these countries are currently achieving annual per capita growth of at least 3 per cent. The partially overlapping groupings of the landlocked and least developed countries and small island developing States are also showing an improvement in growth. All these results demonstrate that progress is possible, even in countries facing the most acute development challenges. Complementary additional national and international policy measures and actions are required to achieve the growth necessary to make inroads into poverty and achieve the Millennium Development Goals. Above all, sustaining and improving growth will

require additional resources and a national, regional and international commitment and support to a stable political environment and to economic restructuring, in particular diversification away from dependence on primary commodities.

The international economic environment

The international economic environment remains generally favourable for developing countries: international trade continues to grow solidly, the rise in the prices of energy and raw materials in 2003 and 2004 has improved the terms of trade for many developing countries, the costs of external financing are at historical lows, and capital inflows are increasing (see table 3).

Table 3
Indicators of the international economic environment, 2000-2004

	2000	*2001*	*2002*	*2003*	*2004*
World trade					
Growth of volume of world exports (percentage)	11.5	-0.5	3.8	6.8	10.9
Value of exports from developing countries (billions of dollars)	2 038.7	1 911.0	2 047.9	2 422.2	2 984.1
United States trade deficit (billions of dollars)	378	362	421	496	516
World prices					
Oil (Brent) (dollars per barrel)	28.3	24.4	25.0	28.9	38.3
Non-fuel commodities (Index: 2000=100)	100	97	97	105	126
Manufactures (Index: 2000=100)	100	98	99	107	116
Real prices of non-fuel commodities (Index: 2000=100)	100.0	99.1	98.0	98.1	108.6
Exchange rate of US dollar					
Nominal trade-weighted index (January 1997=100)	119.4	125.9	126.7	123.2	113.6
Euros per dollar	1.08	1.12	1.06	0.89	0.80
Yen per dollar	107.8	121.5	125.4	115.9	108.7
Financial flows to developing countries (billions of dollars)					
Net transfer of resources	-186.5	-153.7	-205.5	-274.8	-353.8
Official development assistance	53.8	52.4	58.3	69.1	78.6
Net direct investment	148.1	158.6	116.2	132.8	158.3
Global interest rates (percentage)					
LIBOR[a] interest rate	6.6	3.7	1.9	1.2	1.8
Spread on developing country bonds (percentage)	7.5	8.4	7.8	5.6	4.4

Source: UN/DESA, based on Project LINK and international sources.
[a] London Interbank Offered Rate.

The volume of *world trade* increased by almost 11 per cent in 2004 but growth is expected to decelerate to about 8 per cent in 2005 and to stabilize around that level in 2006, as import demand cools off in such major importing countries as the United States, Japan and, to a lesser extent, China and other Asian developing countries.

The recent dynamism in world trade has been closely associated with the further deepening of the international division of labour in production. For example, with the growing relocation of global manufacturing to China, that country's trade has been growing at about 30 per cent annually for the past two years, accounting for almost one fifth of the growth of global trade in 2004. The rise in income and domestic consumption in China — but also in India and other countries in Asia — has generated further increases in the demand for energy and raw materials, further amplifying the growth of exports, and hence gross domestic product (GDP), of many developing countries.

Despite the growing share of developing countries in world trade, final consumption demand in the major developed countries remains the key to the dynamics of international trade. At the same time, the large external imbalances across countries (see below) and the increasing trade tensions among the major economies are beginning to pose threats to both the growth and the new pattern of trade and hence to the development prospects of the developing countries and the economies in transition.

Oil prices rose by an average of about one third in 2004 and continued to increase in the first half of 2005, but it is expected that the growth of world oil demand will soften gradually with slowing world growth. This is forecast to produce a moderation in oil prices in the second half of 2005 and to relieve some of the pressure on oil markets over the medium term. Nonetheless, in a context of tight supply where substantial increases in capacity are likely to materialize slowly, prices are expected to remain at high levels by historical standards and to be volatile. Despite recent easing, oil demand is still growing at a healthy rate and will continue to do so in the medium term.

The Organization of the Petroleum Exporting Countries (OPEC) raised its production quotas by a half million barrels per day in mid-March 2005 and again at the start of May, taking its combined quota to 28 million barrels per day. Substantial increases in Iraq's production — which is not included in the quota — are unlikely in the short and medium run. Nevertheless, there was a build-up in stocks in early 2005, providing support to the view of OPEC that the market is adequately supplied.

Non-OPEC supply, for its part, is expected to rise by 0.9 million barrels per day in 2005; about one third of this additional supply will come from the Russian Federation. Lingering legal and administrative issues affecting upstream investment, as well as investment in export infrastructure, are likely to constrain export growth in the medium term.

Overall, limited spare production capacity remains the chief concern influencing oil markets. Total spare capacity in the first half of 2005 is estimated at between 1.1 and 1.6 million barrels per day and is concentrated almost entirely in Saudi Arabia. The perceived lack of an adequate supply buffer in the presence of potential disruptions associated with geopolitical factors is adding a premium to underlying oil prices.

The *prices of non-oil commodities* are expected to remain largely unchanged in 2005 and 2006 after increases, measured in United States dollars, of 8 per cent in 2003 and 20 per cent in 2004. Measured in special drawing rights (SDRs), however, the increase in 2003 was negligible and in 2004 only 13 per cent, reflecting the depreciation of the dollar vis-à-vis other major currencies in both years.

The strong growth in demand for industrial raw materials — minerals, ores, base metals and agricultural raw materials — in China, India and the developed countries was the major driving forces behind the higher prices. The prices of minerals experienced the sharpest increase. Prices of agricultural commodities — food, tropical beverages and vegetable oils and oilseeds — also increased significantly in 2004. There were no major weather- or market-related supply shocks so that these increases generally reflected growing incomes worldwide.

As a result of increased global supplies and weaker growth of demand, the combined dollar commodity-price index is projected to decline by 2 per cent in 2005 and by a further 4 per cent in 2006. Within the total, the turnaround in the prices of minerals, ores and metals is expected to lag; the average price of these commodities is forecast to increase by a further 8-9 per cent in 2005 but to decline by 10 per cent in 2006. Average prices for food and other agricultural commodities are expected to decline in both 2005 and 2006.

There are signs of increasing tensions in international trade policy, with one recent being found in textiles. The termination of the World Trade Organization Agreement on Textiles and Clothing at the beginning of 2005 has brought considerable changes to the global textile and clothing markets, even though the date was agreed a decade ago in order to allow countries to prepare for the agreed changes. Following the abolition of quotas on 1 January 2005, exports of clothing and textiles from China to the United States of America and Europe surged in the first quarter, triggering two concerns: first, the impact on manufacturers of these products in the developed countries and, second, the consequences for other developing countries that also export textiles. China's exports of textiles to the United States increased by more than 50 per cent in the first quarter of 2005, but some of the other major suppliers to the United States, such as India, Indonesia, Pakistan, Bangladesh, Sri Lanka and Cambodia, were also able to increase their exports. However, African countries receiving preferential treatment under the United States African Growth and Opportunity Act (AGOA) experienced a decline of 25 per cent in the value of their exports during the same period. To alleviate such difficulties, China proposed imposing taxes on its exports of certain textile products, while both the European Union (EU) and the United States warned that they might reimpose restrictions on imports of Chinese textiles. In a first bilateral agreement to resolve these difficulties, China and EU agreed in June 2005 on limitations on Chinese textile exports to EU for a three-year period.

Meanwhile, negotiations on the Doha Development Agenda continue at the World Trade Organization with the aim of producing tangible proposals to be considered by the Sixth Ministerial Conference of the World Trade Organization to be held in Hong Kong Special Administrative Regions (SAR) of China in December 2005 and bringing the Round to a conclusion no later than the end of 2006. A series of mini-Ministerial meetings has injected renewed dynamism into the negotiations, but they remain difficult. Negotiations have not advanced fast enough and there is an urgent need to expedite the process if the Doha Development Agenda is to

contribute to the achievement of the Millennium Development Goals and other internationally agreed development targets.

Calm continues to prevail in international capital markets, with a rare absence of concerns regarding developing countries. The most recent data indicate that net private capital flows to both developing countries and economies in transition in 2004 were both larger than in 2003 and larger than estimated at the end of 2004.[2] In aggregate, these flows are returning to the record levels that had prevailed before the Asian financial crisis of 1997. This may signal the emergence of a positive phase of a new cycle of international financial flows to these countries. Flows of foreign direct investment (FDI) to developing countries, for example, reversed their three-year downward trend in 2004 (see table 3). Revised data indicate that there was also a net inflow of portfolio and equity investment in 2004, rather than the previously estimated outflow, and that the reduction in bank lending was less than projected earlier. The more important development regarding external debt is that many developing countries have been able to take advantage of more favourable financing conditions to restructure their external debt: the yield spreads for external borrowing by developing countries are at historical lows and the underlying "base rate", namely, that on benchmark treasury bonds in major developed countries, is currently unusually low.

The conditions that gave rise to these increased private financial flows to developing countries, particularly the expectation of continuing widespread sound growth in the recipient countries, continue to prevail. This augurs well for a continuation of the positive trend in such flows in 2005 and 2006.

Data on flows of official development assistance (ODA) in 2004 reveal a similar positive trend and reversal of the decreases that characterized the turn of the decade (see table 3). ODA will continue to increase in 2005 and 2006 if donors honour their respective commitments in this regard. Nevertheless, there remain concerns that an excessive proportion of the new flows may be directed to debt relief, emergency aid and reconstruction activities. With regard to debt relief, Finance Ministers of the G-8 agreed in early June 2005 that they would ensure the availability of the resources necessary to provide for the full cancellation of the outstanding debt to the multilateral financial institutions of heavily indebted poor countries (HIPC) that meet certain performance criteria.

Despite these positive developments regarding net financial flows to developing countries, 2004 marked the seventh consecutive year of a net transfer of resources out of developing countries, at a record level of some $350 billion in 2004. Except for sub-Saharan Africa, all developing regions, as well as the economies in transition, experienced a negative net transfer. In an encouraging contrast with most previous periods when negative net transfers had largely been the consequence of capital outflows and rising debt service, the situation in 2004 overwhelmingly reflected a build-up of foreign-exchange reserves by a number of countries with trade surpluses. However, the perceived need for such reserves diverts financial resources from potential use for development purposes to an activity with a highly uncertain return. The return is high only if the reserves are used in a successful attempt by the country to avoid international financial turbulence; otherwise, the return is the low yield offered by the financial assets in which reserves are held. As discussed below, developing countries' decisions to

[2] See *World Economic Situation and Prospects 2005* ..., table III.1; and *World Economic and Social Survey 2005* (United Nations publication, forthcoming), table III.1.

allocate resources in this manner is a response to a major shortcoming of the international financial system which itself should be addressed.

Notwithstanding the seemingly benign situation in international financial markets, there remain risks of a possible deterioration in the external financing conditions for developing countries for reasons that are extraneous to these countries themselves. The first risk is associated with the global imbalances. If the imbalances adjust in a disorderly manner, interest rates in the global capital market are likely to be driven up as the confidence of international investors is eroded. Second, the ongoing monetary tightening in major developed countries is likely to worsen external financing conditions for developing countries. On the other hand, the improvement in the current-account balances in most developing countries over recent years, and the improvement in the external debt situation of some, should have reduced their vulnerability to such external shocks to some degree.

For the poorest countries with limited access to international trade and financial markets, these improved external conditions alone do not provide sufficient impetus for them to achieve the internationally agreed development goals. As called for in the report of the Secretary-General issued in preparation for the high-level meeting of the General Assembly in September 2005 (A/59/2005), entitled "In larger freedom: towards development, security and human rights for all", policymakers in both developed and developing countries should therefore expedite the implementation of their international development commitments of recent years, in particular to increase ODA and to ensure that the development-oriented programme of multilateral trade negotiations agreed at Doha is completed in an equitable and timely fashion.

The macroeconomic policy environment

The majority of countries — developed and developing countries and economies in transition — are experiencing a modest increase in inflation, owing mainly to the higher prices of oil and some raw materials but also to strong demand in some rapidly growing economies. Nevertheless, the inflation rates in many economies are still generally low by the standards of recent decades and within the ranges targeted by the respective central banks. Countries that had relatively high inflation rates in the 1990s, such as a number of economies in Latin America and many of those in transition, have continued to bring down inflation. Among the few countries or areas that were experiencing deflation recently, China and Hong Kong SAR have reversed the trend, but the phenomenon continues to haunt Japan. Overall, therefore, inflation does not appear to be a threat to the global outlook.

Within this generally non-threatening price environment, there has been increasing concern about the substantial rise in housing prices in several developed countries. Housing prices are usually not included in measures of inflation, but they are directly related to monetary conditions and macroeconomic balances. Speculative bubbles can occur in housing prices and, as with financial assets, the bursting of such a bubble could impose a considerable shock on an economy. Views are divided on whether monetary authorities should take housing prices into consideration in their policy stance; however, the risks associated with possible bubbles in housing prices should not be ignored.

Two key reasons for the limited pass-through of the higher prices of energy and raw materials into overall prices and hence into inflation have been the intense competitive pressures worldwide and the pervasively weak employment situation in the global economy, which has constrained increases in wages. Indeed, despite the strong economic growth in 2004, unemployment remains persistently high around the world, with only slow and partial improvements in some regions (see table 4). Based on incomplete data on employment and unemployment in developing countries, it is estimated that global unemployment fell only 500,000 in 2004 (to 184.7 million from 185.2 million in 2003).[3] After three consecutive years of decline, total employment increased by 1.7 per cent in 2004, while world output continued to grow for the whole period. This weak relationship between employment and increases in output is expected to continue in 2005 and 2006. Some improvement is expected in employment in the global economic outlook, but a structural excess supply of labour will continue to prevail in most of the world. It is therefore a global challenge to ensure that the present vigorous growth of global output is paralleled by an increase in employment.

Table 4
Unemployment rate, selected developed economies and regions, 2002-2004
(Percentage)

	2002	*2003*	*2004*
World	6.3	6.3	6.1
Developed economies	6.8	7.4	7.2
EU-15	7.6	8	8
United States	5.8	6	5.5
Japan	5.4	5.3	4.7
South-eastern Europe and CIS	9.4	8.4	8.3
Developing regions			
East Asia	4.1	4.1	4.0
South Asia	4.8	5.0	5.0
Western Asia	9.4	9.4	9.3
Latin America and the Caribbean	9.4	9.3	8.6
Sub-Saharan Africa	10.2	10.2	10.2

Source: ILO, *Global Employment Trends*, BRIEF, February 2005, p. 8; some regional aggregates provided directly by the ILO secretariat.

Monetary policy in the major developed economies remains accommodative but is in the midst of a shift from the stimulatory stance adopted during the previous slowdown to a more neutral policy. Short-term nominal interest rates are 3 per cent in the United States, 2 per cent in the euro area and zero in Japan, but real short-term interest rates are around zero in the United States and in the euro area and are slightly positive in Japan. This indicates that significant monetary stimulus remains, but that its relative strength across the major developed economies is the opposite of

[3] ILO, *Global Employment Trends*, BRIEF, February 2005, available from http://www.ilo.org/public/english/employment/strat/download/get05en.pdf (accessed 21 June 2005).

that suggested by nominal interest rates. Taking into account the effect of exchange-rate movements, monetary conditions tend to be looser in the United States and somewhat tighter in the euro area and Japan. The resurgence in the value of the dollar at the end of May 2005 tempered this effect, but policy generally remains more stimulatory in the United States than in the euro area and Japan.

The current policy trajectory is one of gradually removing, or preparing to remove, this stimulus. The United States Federal Reserve has raised rates by 200 basis points since June 2004 and an increase of another 100 basis points is assumed, bringing short-term interest rates to 4 per cent. In the euro area, policy has remained unchanged since June 2003. In view of the present slow growth in the region, some analysts are calling for a cut in interest rates but many expect the European Central Bank to start raising interest rates to a more neutral level towards the end of 2005. The Bank of Japan is expected to maintain a zero interest rate and the supplement of a heterodox quantitative target until deflation is eradicated. Among the developing countries, many, especially in Asia, are tightening their monetary policy in response to their improvement in growth and increased fears of inflation.

Fiscal policy worldwide is expected to be generally less stimulatory in 2005 and 2006 than in 2004. Government budgets are in deficit in the overwhelming majority of countries and most Governments have announced their intention to improve the situation. Higher oil prices have increased the government revenue of many oil-exporting countries but a number of oil-importing countries have seen their deficits increase, particularly those developing countries that are providing government subsidies to alleviate the impact of higher oil prices.

Global imbalances

The global imbalances continue to widen, with the current-account deficit of the United States expected to expand from some $650 billion in 2004 to over $700 billion in 2005 and to remain in that range in 2006. Conceptually, the global imbalances can be decomposed into three components: cyclical, structural and institutional.

The increase in the global imbalances over the past few years has been driven partly by cyclical factors. For example, the surge in oil prices since 2003 and the policy stimuli to restore the United States economy from the cyclical downturn of 2000-2001 have increased its current-account deficit. At the same time, a number of Asian and Latin American countries have been replenishing their foreign-exchange reserves from the low levels that arose as a result of the various international financial crises of the past decade.

Structural factors, such as a low domestic savings rate and an extended period of higher GDP growth in the United States than in Europe and Japan, have attracted capital to the United States. There have also been structural changes in fiscal policy in the United States, such as tax cuts and increased expenditures on defence and homeland security. Many oil-exporting countries have also continuously — not only in the recent period of higher oil prices — recycled part of their oil revenues to the United States. A major reason for these capital inflows is that the United States has the world's deepest financial market with a wide variety of financial instruments providing safety and liquidity. The global integration of trade and finance has facilitated these capital flows. Other structural factors include the export-led

development strategy adopted by many developing countries, particularly in Asia, which has led to protracted external surpluses in these countries and thus to deficits in their trading partners, including the United States. The quest for trade surpluses and the corresponding accumulation of additional foreign-exchange reserves beyond the levels historically deemed prudent are partly driven by the objective of reducing vulnerability to international financial crises.

Finally, there are institutional factors, particularly in international monetary arrangements, that contribute to global imbalances. The United States dollar acts as the medium of exchange, store of value and unit of account in most international trade and finance transactions. In such an international monetary system, the global demand for United States dollars as a "world currency" can be expected to increase with the growth in the value of flows of international trade and finance. This implies that the United States should run a deficit on its balance of payments (a combination of current account and investment and financial accounts) in order to accommodate the growing need for liquidity in the world economy. Therefore, the system allows the United States, as the issuer of the international reserve currency, to run a continuous external deficit.

Each component of the global imbalances has different implications for the world economy in terms of sustainability, efficiency and equity. For example, given existing international monetary arrangements, the world economy needs a sizeable United States balance-of-payments deficit, increasing over time, so that it has enough additional liquidity to grow. Meanwhile, the part of the imbalances that is attributable to structural differentials among countries may also persist as long as there are national differences in such factors as demographic patterns, savings rates, productivity growth and stable access to external financing that give rise to international flows of financial assets and other resources.

Equally, each component has different policy implications for the adjustment of the global imbalances. The cyclical component, for instance, should be self-adjusting as the relevant cyclical forces abate: if oil prices decline, the United States current-account deficit should narrow. In contrast, the adjustment of the structural component of the imbalances would require actions in both the deficit and the surplus countries to reduce the cross-country structural differentials, while the part of the imbalances that is due to institutional factors can be addressed only by reforms of the international reserve and monetary system.

The notion of a possible exchange-rate-led rebalancing of the world economy is based mainly on the argument that a depreciation of the dollar makes domestically produced goods in the United States relatively cheaper and thus encourages United States consumers to switch their expenditure from imports to domestically produced goods. With the opposite occurring in the surplus countries, the external imbalances should narrow. However, as discussed above, many factors other than the relative prices of tradable goods determine the imbalances, particularly in the case of the dominant reserve currency. Consequently, a depreciation of the dollar alone seems unlikely to be sufficient to return the global imbalances to a sustainable level in a reasonable period of time.

Since it peaked in 2001, the United States dollar has depreciated substantially vis-à-vis a number of major currencies, but the United States external deficit has continued to grow. Some analysts have argued that this overall depreciation has been ineffective because the most relevant exchange rates have not changed: a

number of surplus developing countries (for example, China) have either pegged their currencies to the dollar or have intervened to prevent their currencies from appreciating sufficiently. However, several Asian currencies have already appreciated significantly. In the case of China, the peg to the United States dollar reflects a long-term policy decision that was also maintained when the dollar was strong. Finally, other factors, particularly the large capital inflows that most Asian countries are experiencing, have contributed to reserve accumulation in Asia; theory and practice indicate that there are substantial costs to undertaking a currency appreciation in the face of booming capital inflows.

In the forecast, exchange-rate policy in many surplus countries is expected, in any case, to become more flexible and this may be helpful in global rebalancing although, for reasons analysed previously[4] the impact on the United States external deficit is unlikely to be significant. For example, the Japanese yen has appreciated substantially against the United States dollar since the mid-1980s, but its current-account surplus vis-à-vis the United States continues to grow.

Most analysts and policymakers are becoming increasingly concerned about the sustainability of the current-account deficit of the United States. However, sustainability should be judged not only by the current-account deficit but also by the net foreign asset position of the United States. The difference between the net foreign asset position of the United States and the accumulation of past current-account deficits is the change in the valuation of those assets, due to changes in asset prices and in exchange rates. For example, the decline of the equity market in the United States in 2000-2001 reduced the value of the foreign holdings of United States assets. Conversely, the depreciation of the United States dollar over the past few years has increased the value of the United States holdings of foreign assets (since these assets are denominated in foreign currencies) relative to the value of the United States foreign liabilities (which are denominated in dollars), thereby reducing the net indebtedness of the United States. Although the depreciation of the dollar has not narrowed the United States external deficit, it has improved the sustainability of the deficit by reducing the value of the United States net foreign liability position. Moreover, even with United States net foreign liabilities of more than $2 trillion, the annual inflows of income from United States holdings of foreign assets have always been higher than the outflows on its foreign liabilities.

Therefore, owing to the role of the United States dollar as the international reserve currency and the effect of the dollar depreciation in reducing the value of its net foreign liabilities, the extent of the adjustment required in the current-account deficit of the United States through the real sector, namely, imports and savings, has been reduced. However, the valuation adjustment cannot substitute for the need for an adjustment in the real sector, as the lack of such adjustment may weaken the confidence in the dollar as the major international reserve currency.

The ineffectiveness of the exchange-rate-led adjustment calls for other policies. One possibility is more expansionary policies to boost growth and demand in Europe and Japan and to narrow their economic differentials vis-à-vis the United States. However, Europe and Japan have tried to raise their growth and demand over the past decade, without success. More importantly, reducing the global imbalances by shifting financial assets and resources among the developed countries will not reduce the gap between the rich and the poor in the world. A more desirable approach to rebalancing the global economy would be to promote growth in the

[4] See *World Economic Situation and Prospects 2005* ..., pp. 16-17.

developing countries and to reduce the dependency of global growth on debt-financed demand and the external deficit of the United States.

Regional situation and prospects[5]

Among the developed countries, the economy of the *United States* is expected to grow at 3 per cent in 2005 and 2006, decelerating from 4.4 per cent in 2004. Widening external and domestic imbalances, higher oil prices, tightening monetary policy, less stimulatory fiscal policy, a moderation in productivity growth and the combination of low household savings and mounting household debt are all contributing to the slowdown. On the other hand, some, albeit slow, improvement in employment, low financial costs, strong corporate financial positions and the depreciated exchange rate should continue to support business investment and exports, thereby preventing the economy from decelerating excessively. The major downside risks to this forecast are the large current-account and fiscal deficits and a reversal of the rapid escalation in housing prices.

The *Canadian* economy has been growing slightly below its potential, adjusting to the appreciation of its exchange rate, higher prices of both energy and non-energy commodities and growing competition from developing countries in manufacturing and services. Domestic demand has become the main driver for GDP growth, which is expected to be 2.25-2.75 per cent in 2005-2006.

Despite periodic surges, economic growth in *Japan* remains on a slow track. GDP is expected to increase less than 2 per cent in 2005 and about 2 per cent in 2006. Meanwhile, the economy has not yet extricated itself from its protracted deflation. The index of consumer confidence and some other leading indicators suggest that a recovery in private consumption is on the way, with the employment situation improving slowly and household income no longer declining. Although corporate profits and business investment have been increasing, business sentiment remains cautious, because growth in Japan remains heavily dependent on external demand.

Because of favourable external conditions, both *Australia* and *New Zealand* have again avoided an anticipated moderation in growth. However, increasing capacity constraints, inflationary pressure, an expected weakening in the housing sector, currency appreciation and large current-account deficits are expected to dampen the growth of both economies in 2005-2006.

After a weak performance in the second half of 2004, growth in Western Europe is expected to pick up gradually over the course of 2005 and into 2006. The situation in mid-2005 is tentative, despite preliminary estimates of GDP indicating some rebound in the first quarter. Even with the further improvement expected over the second half of the year, average growth for 2005 will be lower than in 2004 — in EU-15, 2 per cent after 2.2 per cent in 2004, with 2.25 per cent forecast for 2006. Growth is expected to involve an increasing contribution from domestic demand, aided by the expected weakening of oil prices, but net exports will be a continuing drag, as world growth decelerates and competitiveness remains under pressure from further currency appreciation.

[5] More detailed information about macroeconomic developments and prospects in each of the regions is contained in the documents submitted to the meeting of Project LINK, in particular the report by the Secretariat entitled "Global Economic Outlook", available from http://www.un.org/esa/policy/link/index.html.

Growth in the *new EU members* is expected to slow to 4.25 per cent in 2005. The immediate beneficial impact of EU accession turned out to be greater than expected as dismantling the remaining trade barriers bolstered exports. Although currencies in the region in general remain strong as a result of capital inflows, export growth is expected to continue as increases in productivity will maintain the region's competitiveness. Nevertheless, weak demand in EU will reduce the growth of exports while slower real wage growth will dampen private consumption. Implementation of EU-related projects and ongoing FDI should sustain investment growth, as companies from EU-15 are continuing to relocate industrial facilities to the region in their quest to cut production costs.

Some slowdown is expected in the economies of *South-eastern Europe* in 2005, but growth will remain stronger than in the new EU members, supported by both strong exports and domestic demand, especially investment. EU accession remains a dominant policy goal for a number of countries in the subregion.

Growth in the *Commonwealth of Independent States (CIS)* region is expected to moderate in both 2005 and 2006, but will remain above 5 per cent. In addition to the rise in the global demand for and prices of oil, supportive macroeconomic policies, buoyant domestic demand, increasing foreign investment and strong fixed capital formation, mainly in the extractive industries of commodity-exporting countries, have been the main drivers of growth. Growth in the Russian Federation, over 7 per cent in the previous two years, is losing momentum in 2005, reflecting in part the lagged effects of the accumulated real appreciation of the rouble and growing production costs. Household spending is likely to regain its position as a driver of growth in the Russian Federation in 2005-2006. Growth in the other large economies in the region also started decelerating at the beginning of 2005, but is expected to be supported by domestic demand.

Economic growth in *Africa* is forecast to accelerate to more than 5 per cent in 2005, continuing the upward trend of the previous few years. Growth will be driven by increased volumes of oil exports; oil prices that are expected to remain at the higher levels of the past year; strong demand and favourable prices for non-oil commodities; and buoyant domestic demand in most countries. Importantly, the number of conflicts on the continent is at its lowest level for several years. Several countries have benefited from strong growth in tourism revenues, reflecting the growth in global incomes and a spillover from Asian countries that were affected by the tsunami in December 2004. Less favourably, the termination of the General Agreement on Tariffs and Trade (GATT)/World Trade Organization Agreement on Textiles and Clothing on 1 January 2005 has already begun to reduce exports, income and employment in several countries (see above). Growth is expected to accelerate in almost all Northern African countries in 2005.

GDP growth for sub-Saharan Africa, excluding Nigeria and South Africa, is projected to approach 6 per cent in 2005 and 2006, the highest rate for at least a decade. South Africa's growth is expected to increase to 4 per cent in 2005 while Nigeria's is forecast to jump to 7 per cent. In most other sub-Saharan oil-producing countries, continued higher oil revenues and increased public and private consumption are expected to sustain high GDP growth rates in 2005-2006. In contrast, continued political tensions in Côte d'Ivoire and Zimbabwe and a decline in oil production in Gabon will have adverse effects on growth in 2005 and beyond.

Growth in *East Asia* is expected to slow from 7.5 per cent in 2004 to 6.75 per cent in 2005 because of weaker conditions in the developed countries, the persistence of oil prices at the increased levels of the past year and appreciating

exchange rates. A deceleration is expected in almost all economies but growth will remain high. In particular, China's economy is expanding at an annual rate of about 9 per cent, driven by strong exports and continued high levels of investment, but continued restrictive administrative policy measures and bottlenecks in infrastructure and the supply of raw materials are expected to restrain growth somewhat in 2005 and 2006.

Most countries in *South Asia* are expected to maintain their strong growth of the past two years, with the exception of those suffering from the effects of the December 2004 tsunami. A recovery in the tsunami-affected countries is forecast for 2006. A rebound in agriculture, as well as strong domestic consumption and investment, is expected to offset a deceleration in export growth resulting from the deceleration in the developed countries. The industrial sector, especially manufacturing, continues to be the main driver of growth in the region. The rate of gross fixed investment in the major economies picked up notably in 2004 and will continue to increase in 2005. The services sector is also performing strongly, especially in India, where information and communication technologies (ICT) services and business process outsourcing are forecast to grow at about 30 per cent annually over the medium term.

Western Asia is forecast to maintain much of the economic momentum it has gained over the past two years. In the oil-exporting countries, the fact that oil prices are expected to remain at their higher levels will continue to lend strength to the fiscal and external balances and feed into domestic demand. The non-oil sectors will also remain robust in many of these countries, helping to maintain growth as the oil sector nears full capacity and as oil prices weaken somewhat over the medium term. The region's net oil importing countries are forecast to grow by 5.25 per cent in 2005, after 6.5 per cent in 2004. These countries are indirectly benefiting from the region's growing oil revenues through strengthened tourism and financial inflows from the oil-exporting economies, as well as from the restoration of trade and service sector linkages with Iraq. Greater confidence, stemming in part from an improvement in the political and security situation, is a factor behind the stronger domestic demand and financial inflows throughout the region. Nevertheless, there remain downside risks in this respect, particularly the uncertainties surrounding stabilization in Iraq.

Growth in *Latin America* and the *Caribbean* will slow from its rebound in 2004, as external demand eases, economic policy tightens and countries experiencing post-crisis recoveries return to more moderate growth. External conditions for the region will be less favourable, as both the growth of the region's major trading partners and the recent upward trend in export commodity prices are expected to moderate. However, domestic demand will retain some of its momentum and will partially compensate for the slowdown in the exports of the region's net fuel importing countries. For this reason, the Southern Cone is forecast to be the fastest growing subregion. Central America is forecast to grow the most slowly because it will also be affected by weaker demand from the United States. The losses in output due to natural disasters in 2004 and 2005 in the Caribbean countries have been offset by strong inflows of tourism, partly diverted from Asian destinations.